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Russian Federalism: The Decentralisation That Fails

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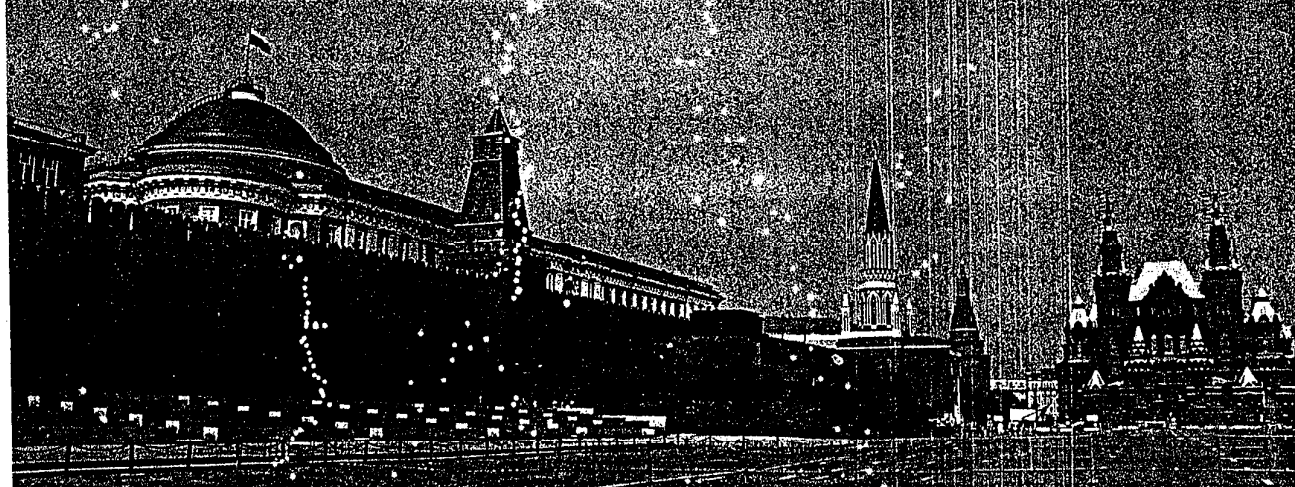
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Russian Federalism

The Decentralisation That Fails



The Kremlin and Red Square in Moscow.

Leonid Polishchuk

THE CRISIS IN RUSSIA IS PERHAPS the gravest in the country's post-communist history. The hard-won stability of prices and the national currency is ruined. Inflation, previously in the single-digits, jumped to over 50% in less than eight weeks in autumn 1998. The rouble has roller-coasted with daily exchange rate swings of up to 30%. Recovery from a decade-long recession has been delayed, at least until the next millennium, by the collapse of the national banking system. The Russian government and the country's public institutions have lost domestic and international credibility through their default on the domestic debt, broken promises and commitments, and weeks of inaction amid the worsening economic crisis.

The new administration in Moscow favours state control of the economy and international trade, inflationary financing of government spending, and Gosplan-style support to domestic producers. This platform, if implemented, would be nothing short of a major reversal of the liberal policies that under-

pinned Russia's transition to a market democracy.

The crisis was prompted, above all else, by the weakness of Russian economic fundamentals, the lack of badly needed restructuring, and the inability of the government to implement necessary reforms and to establish an economic order conducive to investment and growth. These multiple deficiencies have political explanations, which largely centre around federal-provincial relations in Russia.

Federalism is widely regarded as a structure of government that produces efficiency gains and strengthens the protection of political and civil rights. Russian federalism has so far failed on both of these counts. The federal idea has lost much of its earlier appeal in Russia, and many in the country wonder whether a blessing has turned into a curse.

What is wrong with Russian federalism? In a nutshell, it lacks the co-ordinating constraints imposed upon sub-national governments. Without such constraints, federal-provincial relations in Russia are

shaped by short-term preferences of economic and political elites in the regions, and the resulting relations, unsurprisingly, fail tests of economic efficiency, social efficiency and political stability.

Unrooted Federalism

According to the Constitution passed in 1993, Russia is a federation with 89 "subjects". Having established *de jure* a feder-

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al structure in Russia, the Constitution, however, provides only general and rather ambiguous guidelines on the distribution of power between levels of government. Worse yet, whatever little the Constitution prescribes clearly, it is being routinely challenged and violated in everyday life. Ineffectiveness of the Constitution reflects a lack of constitutional culture in Russia, and ultimately an absence of social consensus about the role, authority and responsibilities of the Russian State.

The legal foundations of the Russian federal system are deficient in strength and operational content because federalism does not have solid support in

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Russian society. Federalism did not emerge "organically", responding to a demand from the people for a decentralised state. This kind of organic evolution of federalism could have historic roots, such as when a federation is created by voluntary unification of previously independent units. Alternatively, it could be based on clearly expressed regional self-identification, or produced by a civil society that values the additional checks and balances imposed on the government by a federal system. In Russia, neither the country's history or its nascent civil society call for a federal state, which leaves Russian federalism socially unrooted. Instead, the federal structure of the Russian State accommodated narrowly based economic and political interests.

This rootlessness makes Russia distinct from mature federations, where political behaviour is determined by firmly established "rules of the game" and is therefore a *function* of the rule-making federal institutions. In Russia the causality holds in reverse—federal institutions themselves are being shaped by spontaneously unfolding political processes (and their economic underpinnings). Contrary to widely held expectations prior to the reform, the dismantling of central planning has not depoliticised the economy by separating political and economic processes. The emerging Russian market economy was not allowed to absorb and to resolve the distributional conflicts of post-communist transformations. Russian federalism gives one of the most striking examples that market and state in Russia remain closely intertwined.

Reform and Interregional Disparity

Federations experience serious problems if there are imbalances between responsibilities assigned to central versus sub-national governments, on the one hand, and resources that these governments command, on the other. Russian federalism is impaired by the concentration of financial resources at the federal level, whereas political resources,

such as popular support, are disproportionately concentrated in the regions. This imbalance is produced, in part, by profound economic disparity between Russian regions.

The main cause of the interregional economic inequality in Russia is the structural distortion inherited from the command economy. Non-market principles of industrial location dominated for over seven decades and left spatial economic profiles that are inconsistent with market demand and cannot be sustained in a free-market environment.

Artificial locational decisions encouraged migration and occupational choices that are mismatched with market needs and opportunities.

The structural changes taking place in Russia after 1992, when economic liberalisation began in earnest, were prompted by three main factors—depressed domestic demand and the coincident increasing importance of exports, low competitiveness of Russian manufacturing firms, and the collapse of the military-industrial complex, which previously was the backbone of the Russian economy. The main casualty of central planning is the Russian machine-building industry, the lion's share of which was developed to serve the needs of the military, and which now operates at only a small fraction of its once excessive capacity. Many of the industry's firms, which are often key employers in Russian cities, are narrowly specialised in producing specific components of military hardware, and allow only limited refitting for civil products.

Areas where these and other crisis-stricken industries dominate local economies form the Russian "rust belt", which stretches from Central Russia, through the Urals, the industrialised and coal-mining areas of Siberia, and all the way to the Chita and Amur regions which neighbour China. Severe unemployment and poverty in

these regions are in sharp contrast with the gainers of the reform, including Moscow, which is the hub of Russia's international exchanges, financial system, and government; and the resource-rich areas of Eastern Russia, such as Tjumen region (oil and gas), Krasnoyarsky Kraj (minerals) and Yakutia-Sakha (diamonds and minerals).

These disparities are sustained by low mobility of factors of production in Russia. Interregional labour markets remain suppressed and largely dysfunctional, with migration constrained by the absence of a broadly accessible real-estate market, by continued provision of social services via industrial firms, and by inadequacy of the existing unemployment-insurance system. In violation of the Constitution, administrative restrictions on the choice of place of work and living are still in place. Under these conditions the workforce is sufficiently mobile only within cities. With the investment crisis now approaching its second decade and showing no signs of abatement, this lack of workforce mobility is not compensated by the creation of new jobs in depressed areas.

Thus, several years into the market reform in Russia, the initial pre-reform conditions of a region continue to be critically important for the present economic situation. Moreover, interregional disparities are being exacerbated by a number of spatial inequality "multipliers"—mechanisms that further increase the lead of well-to-do territories and inhibit the development of depressed

areas. An example of such a multiplier is the concentration of trade and services—the most dynamic sectors of the modern Russian economy—in relatively prosperous regions with sufficiently high local demand.

According to official data, the highest level of regional per capita output exceeds the lowest one by 43 times. The average household income in

Moscow is seven times higher than in the regions of Northern Caucasus and Eastern Siberia, the regions worst hit by unemployment and poverty. The dramatic variance in earnings ability in different

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parts of the country, however, is best revealed by indirect indicators, such as the incidence of subsistence activities (for example, the cultivation by urban dwellers of private plots of land). In depressed regions more than two thirds of residents cite such subsistence activities as their main source of wherewithal, supplementing paltry wages that are often delayed for months. In areas of relative prosperity, conversely, this number falls below 10%.

These disparities signal profound deficiencies of the Russian institutional set-up, including poor performance of the labour market and missed prerequisites for investments, such as predictable legal and fiscal regimes, protection of property rights, and overall political stability. In the sober assessment of Anatoly Chubais, one of Russia's chief reformers, "all fundamentals, such as unified legislation, nation's integrity, uniform conditions for economic growth, protection of investments, ... and, last but not least, individual rights—are neither guaranteed nor protected." All of these fundamentals are nation-wide public goods, and their provision is a responsibility of the federal government. The federal government's inability to implement these key functions reflects the aforementioned imbalance between the assignments of responsibilities and resources to different tiers of the Russian federal system.

Political Resources of Moscow and the Regions

In a federal state, the central and sub-national governments both require support in the society. To enjoy such support, the federal government needs a sufficiently strong social consensus on its policies. In Russia, such consensus is hard to achieve because the society is deeply polarised, partly because of the profound interregional disparity. Differences in economic situations of the regions give rise to conflicting regional preferences in such key areas of federal jurisdiction as taxation, transfers to

regions, monetary policies, and international trade.

Conflicts of regional interests, deep as they are, are further sharpened by the Russian system of public finance. Federal taxes in Russia represent over 85% of total tax revenue and are shared with the regions through several channels. This makes Moscow and the regions key agents in the massive extra-market redistribution of national income, a process that is inevitable given the inability of Russian markets to accomplish the required reallocation of factors of pro-



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duction. In this redistribution, about 10% of regions are "donors" (the city of Moscow and the Tyumen region—Russia's sub-polar oil and gas "emirate"—alone contribute over a third of all budget revenue), whereas the rest of the regions are net recipients of federal subsidies.

Moreover, changes in the Russian economy have narrowed the political horizons of the regional population. Regional authorities have largely supplanted the federal government in the political preference of Russian voters, who view federal policy issues as much less relevant to their everyday lives, than those on the regional agendas. This is partly due to the fact that after the federal government abandoned most of the subsidies to enterprises and social transfers to households, many of these

functions were assumed by regional administrations. The main cause, however, is the disintegration of the Russian economic space, which leads to a political fragmentation of the country.

Prior to the economic reforms, economic exchanges between Russian regions were intense, reflecting the bias of central planners toward concentration of production by a few industrial giants. Typically such mega-firms, based in various regions, were serving the rest of the country, so it was common to have suppliers and/or customers thousands of miles away. Tight government control over international trade left few alternatives to domestic producers, and the insulation from global markets further expanded economic links between Russian regions.

These economic links have disintegrated with an abrupt opening of the Russian economy to market forces and the liberalisation of foreign trade, which reduced trade between Russian regions to levels never before seen. Russian producers (if they don't operate in protected resource

industries) manage to maintain their market presence only in services, where competition from imports is technically infeasible, and in a few other sectors where products feature high transportation costs. Therefore, at present, the main comparative advantage of Russian firms comes from natural geography—space and access to natural resources. Russian producers are thus oriented mostly toward either local (intra-regional) or global markets, whereas interregional economic links have suffered a steep decline.

High transportation tariffs, the habitual non-payments for deliveries by Russian firms, and overall weakness of domestic demand suppress interregional exchanges even further.

Under such circumstances, market agents cease to be concerned about

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nation-wide economic conditions. They lose interest in the actions of the federal government, with a notable exception of their fiscal policies. Moreover, deep interregional inequality reveals the inability of the federal government to guarantee basic economic and social rights. A natural reaction to this failure of the federal authorities is to seek protection of these rights at the regional level. As a result, the federal government loses further support.

Regional authorities find it easier to consolidate their political bases, and enjoy more than twice as much support in the society as their federal counterparts. This discrepancy reflects the implicit "division of labour" between the federal centre, which until recently carried out painful policies of fiscal stabilisation, and regional administrations which have assumed responsibilities for direct support of firms and households. In the fields which do have federal jurisdiction the regional authorities are more frequently serving as intermediaries between the centre, on the one hand, and individuals and firms, on the other. In particular, regional leaders often put their political clout behind insolvent firms being targeted by the federal government for bankruptcy. In one telling illustration, while the federal authorities in Russia were seeking to prosecute Siberian coal miners who protested against wage arrears by blocking railways, the regional governor argued that "it would be fairer to initiate criminal proceedings against the federal government for illegally closing mines, failing to find new work for laid-off miners, and failing to pay miners' wages."

"Bargaining Federalism" Russian Style

Lacking direct political support in the society, the federal government had to seek its support from regional administrations that have much stronger political bases. This asymmetry created preconditions for deals in which political loyalty was exchanged for expanded jurisdictions and economic resources. Regions have a reciprocal need in such exchanges. Given the huge discrepancy in regions' fiscal capacities and the inevitably massive redistribution of tax revenue, relations with federal authorities are critically important for a region.

The importance of this relationship creates a strong mutual interest in a non-politicised dialogue between Moscow and regional administrations. Such interest in part explains the constructive partnership that the federal government maintained until recently with most of the regional governors, including those who, prior to their election, were in opposition to the Kremlin. A non-partisan "good manager"—a pragmatic centrist driven by local needs and concerns—is optimal for a regional leader. Political parties in their traditional meaning are redundant in this configuration—in one governor's words, "my party is my region".

"Bargaining federalism" that has emerged in Russia clearly violates the central idea of a federal state—the division of power between tiers of government, and independence of each of the levels within its jurisdiction. Of course, complete insulation of regional governments from the federal one is impractical, but in stable federations dialogue between the levels of government is not required for its day-to-day operations, and usually serves for "fine tuning" of federal-provincial relations. In Russia, on the contrary, such dialogue is central to the country's federal system and supplants the constitutional basis. Unrestricted bargaining has distorted activities at both levels of government, and has led to economic losses and political instability, both of which threaten the unity of the Russian State.

The federal government's actions depend on the approval and support of the regional authorities, rather than on the directly expressed will of a majority of the country's population. Such substitution deprives the federal authorities of their executive independence. In a "bargaining" federation the very ability of the centre to provide fundamental public goods within its jurisdiction, such as nation-wide market infrastructure, law and order, protection of basic economic rights of property and contracts, and social safety nets are called into question. Indeed, the centre can expend its financial and political resources on either provision of such public goods or

on subsidies and concessions to regions. Regional leaders prefer subsidies, which is natural for a politician fully accountable to the regional interests. As a result, provision by the federal government of mandated public goods is crowded out by direct and indirect subsidies. The resulting "inaction" of the centre is often blamed on a "lack of political will", whereas the real culprit is a lack of political resources.

It should come as no surprise that under such conditions the federal government has failed to implement systemic changes required for an economic turnaround. The shrinking tax base, extensive subsidies and transfers, and poor revenue collection were

forcing the federal government to cover its budget deficit by heavy borrowing domestically and internationally. To attract investors to an increasingly risky gamble, the Russian government was offering a premium on its debt of as high as 50%. In August 1998 the state-run "pyramid" collapsed, causing the government to default on its domestic debt.

The system of bargaining federalism strongly affected the behaviour of regional authorities as well. All of Russia's regional leaders are now elected, which makes them politically independent from the centre and accountable to voters in their regions. This is a step toward true federalism, since regional leaders have obtained their own political resources and are free to use them in the interests of their regions without seeking an endorsement of the federal government. This is, however, only a necessary condition for efficiency of a federal system. It is not sufficient because it concerns only the political preferences of sub-national governments, and is mute on how their policy goals could be achieved. Regional leaders face a fundamental choice between concentrating their efforts within regions or trying to cut a better deal with Moscow. In other words, they must choose between productive efforts and rent seeking.

Given the lack of constitutional safeguards and the political vulnerability of

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the central government, lobbying was and remains the activity of choice for regional politicians. In the early 1990s the principal domain for rent seeking within the Russian federal system was in intergovernmental fiscal relations, where discretion reigned and almost all of the fiscal arrangements were subject to negotiations. The Russian finance minister recently concluded that "... there are no general rules in relations between Moscow and regions, just individualised political bargaining".

Later attempts of the federal government to introduce such rules were at least partially successful. This includes formulas for sharing federal taxes between the centre and regions, and a replacement of the earlier non-transparent system of subsidies to needy regions by formula-based equalisation transfers from the Regional Financial Support Fund. Besides, the severe budget deficit prompted across-the-board cuts of federal expenditures, including transfers to regions. As a result, old-style fiscal bargaining lost its attraction to regional lobbyists.

However, rent seeking by Russian regional leaders survived these changes. Lobbies simply changed their tactics by shifting targets into the field of legal reform, with the purpose of not just extracting one-time subsidies, but instead securing additional powers and sources of economic rent for a region. New forms of bargaining with the federal government are particularly appealing for the regions, since legally sealed deals offer a hedge against political and budgetary uncertainty at the federal level, and at the same time allow a region to strengthen its position in future conflicts with Moscow.

By mid-1998 treaties on delineation of jurisdictions and power were signed by the federal government with 46 out of the 89 subjects of the Russian Federation. Every treaty comes with a package of agreements on economic, fiscal and other issues. It is noteworthy that these agreements reach into such areas as property rights, and financial, foreign-exchange and customs policies, all of which form a core of the federal jurisdiction. It is common knowledge that the size and scope of concessions to a region sealed in a treaty with the federal government are determined first and foremost by the political clout of the

regional administration. As put by a political advisor to the president of Tatarstan, "every subject [of Russian Federation] signs a treaty that it can afford".

Assessment of "Bargaining Federalism"

Intergovernmental communications and interactions are inevitable in the process of building a federal system in Russia, and in principle could play a useful role. Lobbying by regional authorities is, among other things, a means to articulate regional interests and to reflect those interests in federal laws and policies. However, regions clearly give a priority to bilateral treaties and agreements that provide "judicial enclosures" of local interests. In other words, instead of influencing laws that apply throughout the Russian Federation, regions attempt to reduce their exposure to federal legislation and to remove themselves as much as possible from the federal legal domain. When such patterns become common, treaties crowd out and supplant constitutional norms. Moreover, regions resist—through their representation in the upper chamber of the Russian parliament—the passing of federal laws that are intended to establish a uniform structure in federal-provincial relations and therefore would pose an obstacle for securing exclusive legal arrangements.

Russian regions used the opportunity in various ways to expand *de jure* and *de facto* their rights in establishing fiscal, institutional and legal regimes. The spectrum of such regimes that has emerged in Russia includes "liberal" and "conservative" models, as well as numerous combinations of market freedoms and administrative controls, private and public enterprise, and different patterns of property rights, among other things. Such variety could be potentially useful, as it deprives the federal government of monopoly over the choice of economic policies, and effectively creates a market for legal and institutional frameworks, which in its turn opens ways for experimentation and competitive selection of the best options.

However, as was pointed out by Barry Weingast, a Stanford University scholar of federalism, such markets work properly only under two conditions. The first is unhampered interregional mobility of

factors of production. Freedom of movement of population and investments allows "voting with one's feet" against bad policies. This makes competitive selection not just feasible, but practically assured, since it is driven by powerful economic and political incentives of regional leaders. The second condition is that regional governments should be subject to co-ordinating constraints that assure consistency of regional policies with each other and with nation-wide requirements of economic efficiency, and prevent "beggar-thy-neighbour" actions. Central to this condition are hard budget constraints of regional governments, forcing them to rely on their own revenue sources, and transparent and rules-based intergovernmental transfers. Hard budget constraints exclude *ad hoc* fiscal arrangements, federal bailouts and haggling about regional jurisdictions and tax bases.

None of these conditions are met in Russia. As was already mentioned, interregional mobility of labour and capital remains constrained. Imperfections of economic markets for factors of production therefore lead to failures of political markets for institutional regimes in Russian regions. It also follows from the previous analysis that constraints imposed upon regional governments remain loose and could be relaxed *de jure* and/or *de facto*. "Liberating rules" (in Richard Posner's terminology) have not been established in the Russian federal system.

As a result, Russia features a patchwork of different and incompatible institutional regimes, which hampers interregional exchanges and contracts, and distorts market signals. Inconsistency and plicancy of federal and regional laws deters investors who are concerned about predictability and legal protection. Investment projects in the regions still require personal endorsement of governors. After the recent victory of Alexander Lebed at the gubernatorial elections in the Krasnoyarsk region, some of the previously negotiated contracts were suspended, since they relied on guarantees issued by the defeated incumbent.

Looking Into the Future

Lacking firm constitutional foundations, Russian federalism is exposed to the strong influence of political and economic cycles. At the early stage of the reforms,

amidst political uncertainty and an acute economic crisis, the federal government—first voluntarily and later yielding to pressure—was increasingly surrendering its power to the regions. This process developed features of a chain reaction. The inability of the federal government either to reward loyal regional leaders or to punish transgressors prompted more and more regions into the “sovereignty parade”. To break this trend, the federal authorities had to resort to a show of force, in their turn overstepping the boundaries of the then existing Constitution. Tanks deployed on the streets of Moscow in October 1993 were shelling at the building of the recalcitrant parliament; but the message was equally addressed to unruly regional leaders. The effect of the measure, while initially strong, turned out to be short-lived. The political base of the federal centre remained shaky, and uncertainty surrounding the outcome of the 1996 presidential elections, combined with the failure of the Chechen campaign, again strengthened the position of regional elites, which then initiated a new round of the “federal cycle”.

The exigency of the mounting financial crisis put the Kremlin again on an offensive. The government of Sergei Kirienko, brought to office by President Yeltsin in the spring of 1998 with a mandate to accelerate reforms, announced a set of policy measures. These included a suspension of bilateral treaties in contradiction with the federal budget, sanctions against regions which are in non-compliance with the federal tax laws, and requirements to eliminate regional subsidies and reduce wage arrears. However, lacking political resources just as badly as its predecessors, the Kirienko government failed to implement its mandate and was swept aside by the recent crisis. Regional governments immediately responded to the ensuing vacuum of power by imposing local price controls, prohibiting exports of locally produced goods outside of the region, and declaring “fiscal sovereignty” to divert all

locally collected federal taxes to regional budgets. Facing the collapse of Russian banking, regions attempted to create pools of local banks insulated from the rest of the Russian financial system. The Kemerovo region and Yakutia announced their efforts to create local gold reserves, with regional “central banks” as the next natural step.

It remains unclear whether this process will retain its cyclical nature, or will converge to a stable federal regime. Without binding and enforceable consti-

the necessary transparency of public sectors in regions. It is symptomatic that some regions did not follow the central government's lead and refrained from defaulting on their own debt. Competing for investments, regions adopt from each other the innovations that work toward these ends.

However, this process does not exclude lobbying efforts of the regional administrations, which still retain ample opportunities for rent seeking. The strive of regional leaders for the economic prosperity of their own territories is insufficient to strengthen and protect the nation-wide market—the latter requires broader based supra-regional interests. Otherwise competitive selection leads to proliferation of not only economically efficient innovations, but also of those that could become an obstacle to the formation of national markets—clearly illustrated by the explosion of treaties between regions and the federal government.

One can expect that truly nation-wide, encompassing interests capable of providing a solid political basis for the federal centre, could emerge as a result of expansion into the regions of the largest Russian banks (that are currently merging with each other to weather the crisis), and of continuing growth of financial-industrial groups and conglomerates. The latter could replace regional authorities as a source of support for the federal government, especially at a time of financial emergency.

However, deficiencies of the Russian federal system currently remain in the way of reforms leading to economic stabilisation and growth. Today the country is at a crossroad. Regardless of the future policies of the central government, Russia will have to deal with the same vicious circle—without an improvement in its economic situation the centre cannot count on support in the society, and without such support its ability to implement the necessary policies will remain severely constrained. Breaking this deadlock will be anything but easy. ♦



The White House, home of the Russian Parliament.

tutional constraints, the question largely depends on the configuration of economic and political interests in the country. The intention of the new government headed by Yevgeny Primakov to broadly resort to transfers and subsidies funded through a “controlled inflation” creates an environment conducive for regional lobbying. While at the time this article is written the first practical steps of Primakov's cabinet are still to be seen, there are three factors that recently have come into play that could be of importance in the long run. First, the increased need in the regions to attract private investment. Second, an active expansion into the regions of large banks and financial-industrial groups. And third, the strengthening of local self-government.

With federal transfers becoming increasingly unreliable, regional authorities are turning more to financial markets as a source of funds. Such attempts can only be successful if regions are able to offer attractive tax regimes, provide investors with sufficiently credible guarantees of loan re-payments, and achieve

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